DIRECT TESTIMONY
OF
CAREY FLYNT
ON BEHALF OF
THE SOUTH CAROLINA OFFICE OF REGULATORY STAFF
DOCKET NO. 2005-113-G

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND OCCUPATION.

A. My name is Carey Flynt. My business address is 1441 Main Street, Suite 300, Columbia, South Carolina 29201. I am employed by the State of South Carolina as Manager of the Gas Department for the South Carolina Office of Regulatory Staff ("ORS").

Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A. I received a Bachelor of Science Degree in Business Administration, with a major in Accounting from the University of South Carolina in Columbia in 1975. I was employed at that time in the electric and gas utility industry and have twenty-five years experience in this field. I was employed by the South Carolina Office of Regulatory Staff in October, 2004 in my present position. I have testified on numerous occasions before the Public Service Commission of South Carolina ("Commission") in conjunction with natural gas issues.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony in this proceeding is to provide the Commission with information in support of the comprehensive Settlement Agreement ("Settlement" or "Settlement Agreement") entered into on August 10, 2005 by all the Parties to Docket No. 2005-113-G. In that Settlement Agreement, the Parties agreed to a resolution of all issues in the case and stipulated that the rates and tariffs attached to the Settlement Agreement would result in rates, terms and conditions for gas service by South Carolina Electric & Gas ("SCE&G") that were fair, just and reasonable. The Parties further stipulated that the accounting adjustments and financial data contained in the Settlement Agreement and its attachments were just and reasonable and should be used for setting rates in this matter.

A copy of the Settlement Agreement and its attachments was filed with the Commission on August 10, 2005. On August 23, 2005, the Commission issued a directive asking the Parties to provide the Commission with additional information related to seven specific topics to assist in the review of the Settlement Agreement.

Q. WHAT SPECIFIC TOPICS DO YOU ADDRESS IN YOUR TESTIMONY?

A. This testimony is filed in response to the Commission's directive of August 23. Specifically, my testimony describes the process by which ORS determined that the Settlement Agreement was just and reasonable and in the public interest. In addition, my testimony addresses the information requested by the Commission in the August 23, 2005 directive.

Q. PLEASE EXPLAIN THE ROLE OF ORS IN REVIEWING THE RATES AGREED TO IN THE SETTLEMENT.

A. By law, ORS is charged with representing "the public interest of South Carolina" in matters before the Commission. S.C. Code Ann. §58-4-10 (B)(2005). Under its statutes, ORS is charged with balancing the interests of all parties to rate making proceedings including residential, commercial and industrial customer classes, and the utility applicant as well as the interests of the State of South Carolina as a whole in regulatory matters. S.C. Code Ann. §58-4-10 (B)(2005). One of the key interests that ORS is expressly required to protect is the interest of the "using and consuming public, regardless of class of customer." S.C. Code Ann. §58-4-10 (B)(1).

Consistent with its statutory mandate, ORS is particularly concerned about safeguarding the interests of all classes of customers, including the residential customers of SCE&G's gas system. Residential customers are SCE&G's largest group of customers both in terms of the number of customers represented and the demands that these customers place on the system. The residential customer group includes many people who rely on gas for heating their homes in the winter and many people whose financial situations may make them more sensitive to rate increases. As a result, ORS understands one of its duties is to protect the interest of residential customers in proceedings related to retail gas rates.

Q. WHAT DID ORS DO TO RESPOND TO THE ISSUES RAISED IN THIS DOCKET?

A. In its evaluation of the issues raised in Docket 2005-113-G, ORS reviewed the Application and supporting documentation. ORS conducted significant on-site discovery and served approximately 100 Data Requests on SCE&G seeking further information from the Company. ORS's audit staff audited the Company's books and records to verify financial information relevant to SCE&G's Application and to identify adjustments to revenue, expense or investment accounts that were not proposed by the Company. ORS evaluated the material issues in the case utilizing the expertise and experience of the utility experts, analysts, accountants, auditors and the economist on its staff.

ORS performed this work pursuant to its statutory obligation to represent the interests of the State of South Carolina and fairly balance the interests of all parties in the proceeding. In evaluating settlement proposals in this proceeding, ORS focused specifically on whether the resulting rate design was fair and reasonable to all, including the residential customers of SCE&G's system.

Q. HOW DID ORS REVIEW THE RATE DESIGN IN THIS PROCEEDING?

A. On June 8, 2005 and on June 30, 2005, the ORS served Data Requests on the Company. In those requests, ORS sought information to allow it to review and evaluate the Company's proposed rate design. Through those requests ORS obtained: a) the Company's fully allocated Cost of Service Study which was used in the development of its proposed rate design; b) a detailed explanation and justification of the allocation factors and methodologies used in the Cost of Service Study; and c) schedules showing the rates of return by class of service under both current and proposed rates. Furthermore, ORS sought and received from the Company information concerning

a) the mark-up in dollars and cents for each presently approved rate schedule and each proposed rate schedule;
b) the cost studies used to develop any increases or changes in facilities charges;
c) a written statement of all changes and the reasons for changes in current rate schedules and general terms and conditions apart from changes in rates;
d) a comparison by rate of all costs to customers using present and proposed rates;
e) the number of customers, sales volumes, and revenues for each rate schedule;
f) the margin and facilities revenue derived from each rate schedule under present and proposed rates;
g) a five year history of the number of customers under all active rate schedules;
h) the revenue and dekatherm usage of gas for all classes of service for five years;
i) a description of the key factors affecting gas usage by customer class; and
j) the annual bill comparisons using present and proposed rates.

ORS reviewed the Cost of Service Study, including the allocation factors used in that study, and the supporting data submitted by the Company. As part of ORS's audit of the Company's Application and supporting documents, ORS verified that the data on which the study relied was accurate and the allocation factors it used were appropriate.

Q. WHAT DID ORS CONCLUDE?

A. Based on its review and audit, ORS concluded that, for purposes of reviewing the rates proposed in this proceeding, the basis used to perform the Cost of Service Study submitted by SCE&G fairly and accurately represented a reasonable distribution of revenues, costs and rate-base items to the various customer classes. ORS also concluded that the allocation factors used in that study properly reflected the principles of cost-causation.

Q. WHAT DID THE COST OF SERVICE STUDY SHOW?

A. The Settlement Cost of Service Study, prior to any rate increase, showed the rate of the return for service to the residential class was a negative 2.94% for the test year. Other firm customer classes provided positive returns during the test period. However, taking all the customer classes together, the combined rate of return on SCE&G's gas operations for the test period was 3.19%.

Q. WHAT DID ORS CONCLUDE BASED ON THE SETTLEMENT COST OF SERVICE STUDY?

A. The Settlement Cost of Service Study showed that of all the firm customer classes, the residential class had a rate of return that was the farthest out of alignment as compared to other classes of service.

Q. WHY WOULD THIS BE THE CASE?

A. Over time, the rates of return between customer classes shift as the factors driving returns by class change. Rates of return for customer classes depend on factors such as the level of firm demand that customer classes place on the gas system, the amount of revenue derived from service to individual customer classes, and the amount of investments made to serve individual customer classes. As these factors change, rates of return change.

It is not unusual that the rate of return of a large and growing customer class like the residential customer class would have deteriorated relative to other classes since the present base-rates were last approved by the Commission.

Q. HOW DID THE RATE OF RETURN EARNED FROM THE RESIDENTIAL CUSTOMER CLASS AFFECT THE SETTLEMENT OF THIS CASE?

A. Because the residential customer class was starting from a low rate of return, ORS was concerned about the level of increase that would be required to bring the residential rate of return into parity with other classes. In the case of SCE&G's gas operations, the overall rate of return required to produce a 10.25% return on equity is 8.43%. It was clear from our review of the Cost of Service Study that an attempt to bring the residential rate of return from -2.94% to +8.43% at this time would be unreasonable and disruptive.

Q. HOW DID ORS RESPOND?

A. In the Settlement Agreement, the Parties accepted a rate design that increased the rate of return for the residential class from -2.94% to a +3.76%. This 3.76% return is still below the level of 8.43%, and it is below the rate of return that could be earned on any other customer class under the Settlement rates. However, this rate design does represent a movement of the residential customer class rate of return toward parity and provides that SCE&G will have the opportunity to earn a positive return on its residential service under the new rates.

Q. WHAT IS ORS'S OVERALL CONCLUSION ABOUT THE RATE DESIGN PROPOSED IN THE SETTLEMENT?

A. ORS's conclusion is that the rate design contained in the tariffs attached to the Settlement Agreement is just and reasonable, that it supports the public interest of the State of South Carolina and reasonably balances the interests of the Company and all customer classes. Specifically, the rate design reflected in the Settlement protects the residential customer class by avoiding too large a one-time increase in rates but nonetheless moves the residential customer class closer to the parity rate.

Q. PLEASE DESCRIBE THE RESIDENTIAL VALUE RATE AGREED TO IN THE SETTLEMENT.

A. In its Application, SCE&G proposed the creation of a new Residential Value Rate that would provide a per therm discount to residential customers using ten (10) or more therms of gas on average during the summer months of June, July and August. The rationale for the new rate is that the rate discount will provide an incentive for customers and builders to add non-weather sensitive natural gas appliances to the system, such as gas water heaters, dryers and stoves. The addition of these appliances to the system can be beneficial for all customers since summer use of gas can improve the economics of the system for all customers.

Q. PLEASE EXPLAIN.

A. From a cost of service standpoint, the Company incurs the same costs to maintain its gas distribution facilities and its other fixed assets whether or not customers use substantial quantities of gas in the summer. Customers who use non-weather sensitive natural gas appliances provide year-round revenue that contributes to the fixed costs and reduces the costs that must otherwise be recovered from other customers. All residential customers, as a class, benefit if the Company increases its load during the summer months. ORS believes that, the rates agreed to in the Settlement encourage summer use and can result in benefits to all firm customers.

Q. PLEASE DESCRIBE THE REVIEW AND ANALYSIS THAT ORS CONDUCTED CONCERNING SCE&G'S PROPOSED RESIDENTIAL VALUE RATE.

A. ORS reviewed the data supporting the Residential Value Rate. Approximately 38% of existing gas customers would qualify for the program.

Those customers already provide benefits to the system in the form of the increased summer consumption, and in the form of the increased margin revenue they represent. ORS believes that gas customers who have nonweather sensitive appliances could qualify for the program, even those in modest homes.

Q. HAS THIS COMMISSION APPROVED SIMILAR RATES FOR OTHER COMPANIES?

A. Yes. In Order No. 2002-761, p. 68, the Commission approved a similar residential value rate for Piedmont Natural Gas Company. That order states that "the Commission finds and concludes that the bifurcation of residential rates into a Value Rate and a Standard Rate service as proposed by the Company will better reflect cost causation principles, and will serve to promote a more efficient utilization of gas and is just and reasonable." These same considerations of cost causation and efficient utilization of the gas system support the Residential Value Rate agreed to in the Settlement. ORS's decision to support the creation of this new rate was based on the potential benefits to all gas customers from increasing gas load on SCE&G's system during the summer.

Q. WHAT POSITION DOES ORS TAKE WITH REGARDS TO THE 10 THERM AVERAGE SUMMER USE REQUIRED TO QUALIFY FOR THE VALUE RATE?

A. ORS determined that the ten (10) therm minimum summer usage required to qualify for the rate is set low enough that it will not unfairly discriminate against any group of residential customers with non-weather sensitive loads. Customers who have non-weather sensitive appliances, but due to income or other reasons use gas more sparingly than others, can still qualify for the rate at the ten (10) therm level.

Q. HOW DOES THE 10 THERM LEVEL COMPARE TO THE LEVEL REQUIRED TO QUALIFY FOR RESIDENTIAL VALUE RATES ON OTHER SYSTEMS?

A. In Order No. 2002-761, at p. 66-68, the Public Service Commission approved a similar value rate for Piedmont Natural Gas Company with a qualifying average summer use of 15 therms. This threshold usage is 50% higher than the threshold use as agreed to in the Settlement.

Q. PLEASE RESPOND TO THE CONCERN THAT THE INCREASE IN RATES PROPOSED HERE WILL CAUSE CUSTOMERS TO CONSERVE GAS AND FAIL TO QUALIFY FOR THE VALUE RATE?

A. ORS does not believe the rate increase in the Settlement will result in a substantial number of customers changing their summer gas consumption enough to cause them to fail to qualify for the Residential Value Rate. The rationale for the rate is that it will encourage customers and builders who are making choices about which appliances to install to choose gas appliances for non-weather sensitive applications, thereby increasing the number of customers qualifying for the rate.

Q. PLEASE EXPLAIN ORS'S POSITION WITH REFERENCE TO THE COMPANY'S PROPOSAL TO CREATE A NEW RATE 33.

A. In its Application, the Company proposed creating a New Rate 33 for general service (commercial) customers. This rate will be open to general service customers using more than 130 therms of gas on average during the summer months of June, July and August. These customers would receive a discount in the per therm price for gas service under the rate. A principal reason for the proposed rate is to provide marketing incentives to help persuade commercial customers to install non-weather sensitive gas appliances for such things as commercial cooking grills, ovens, dryers and water heaters for commercial laundries, motels and condominiums.

ORS reviewed SCE&G's data and determined that 20% of commercial customers will qualify for Rate 33. However, these customers will represent approximately 70% of the overall general service load on SCE&G's gas system. On average, customers qualifying for this rate generate higher revenues than the average revenue per commercial customer generally.

ORS's decision to support Rate 33 is based on its conclusion that commercial customers with high summer use do indeed provide benefits to SCE&G's gas distribution system through the margins they generate. Providing these customers with a discounted rate is appropriate from a cost causation standpoint. But of equal importance, a discounted rate should give SCE&G's

marketing personnel a useful incentive to offer commercial customers who are making the decision to rely on gas versus propane or other energy sources for non-weather sensitive applications.

Based on its review of these matters, ORS concluded that the proposed Rate 33 will provide benefits to the gas system as a whole and is appropriate for adoption in this proceeding.

Q. UNDER THE SETTLEMENT, WILL THE INDUSTRIAL SALES PROGRAM RIDER CONTINUE?

A. Yes. The Settlement Agreement specifically provides for continued authority for the Company to price interruptible gas sales to alternative fuel customers on a competitive basis under its Industrial Sales Program-Rider ("ISP-R").

Q. IS CONTINUING THE ISP-R PROGRAM IN THE PUBLIC INTEREST?

A. Yes. The pricing flexibility contained in the ISP-R is very important to maintaining interruptible load on SCE&G's system in the face of competition from alternative fuels and earning reasonable margins from serving interruptible customers. Under the cost of gas mechanism agreed to in the Settlement, net margin revenues from ISP-R and other interruptible service will be credited directly to firm customers to reduce their cost of gas. (Net interruptible margins are the revenue from the interruptible sales less the cost of gas, less a $0.02081 per therm contribution to SCE&G's cost of serving interruptible customers.) For this reason, it is in the interest of residential, commercial and firm industrial customers that SCE&G be allowed to continue to use the pricing flexibility that the ISP-R program represents.

Q. FROM THE ISP-R CUSTOMER'S PERSPECTIVE, WILL THE COST OF GAS METHODOLOGY CONTAINED IN THE SETTLEMENT CHANGE HOW THE ISP-R PROGRAM FUNCTIONS?

A. No. From a customer's perspective, the cost of gas methodology stipulated to in the Settlement will not change the ISP-R program in any significant way. The Company will still have flexibility to make competitive bids based on customers' alternative fuel prices.

Q. WHAT WILL CHANGE?

A. All that will change is how costs and margins are handled for accounting purposes after an ISP-R sale is made.

Q. WILL THE ISP-R PROGRAM FUNCTION PROPERLY UNDER THE COST OF GAS METHODOLOGY CONTAINED IN THE SETTLEMENT?

A. Yes. ORS reviewed the cost of gas mechanism and finds that it will function as intended and is compatible with the pricing under the ISP-R program. The new cost of gas mechanism will ensure that the net margins earned by the Company, after the deduction of its direct costs of interruptible sales, will flow through to firm customers in a fair, transparent, and equitable basis.

Q. EXPLAIN MODIFICATIONS TO THE COST OF GAS FACTOR CALCULATION INCLUDED IN THE SETTLEMENT AGREEMENT.

A. In the Settlement, the Parties agreed to a two-part Purchased Gas Adjustment ("PGA") factor. There will be a Firm Commodity Benchmark which applies to all firm customers. In addition, each customer class will have a specific Demand Charges component of its cost of gas factor that represents the fixed cost of upstream capacity and related expenses. These capacity charges and related expenses will be allocated to customer classes according to their contribution to peak design day demand.

Q. IS THE TWO-PART DEMAND COMMODITY RATE STRUCTURE BASED ON PROPER ALLOCATION FACTORS?

A. Yes. The allocation factors are contained in the Cost of Service Study and have been reviewed and audited by ORS and are accurate and appropriate. We note that they will be updated in each annual PGA proceeding, so the most current factors will be used in the allocation of fixed demand charges..

Q. IS THE TWO-PART DEMAND COMMODITY RATE STRUCTURE JUSTIFIED?

A. Yes. ORS supports the two-part cost of gas factor agreed to in the Settlement because it better matches cost causation with cost recovery, specifically because it includes a demand-based allocation of fixed upstream capacity costs. These capacity costs are, in fact, demand related costs and it is preferable to allocate them among customer classes using demand-related allocators as the Settlement proposes.

Q. IS THIS TWO-PART STRUCTURE CONSISTENT WITH HOW OTHER GAS DISTRIBUTION UTILITIES ALLOCATE THEIR GAS SUPPLY COSTS?

A. Yes. The other investor owned gas distribution utility in South Carolina, Piedmont Natural Gas Company separately accounts for gas commodity costs and fixed upstream capacity related costs. Furthermore, in Piedmont's most recent rate order, the Commission approved the allocation of upstream capacity costs among customer classes based on demand allocators and approved the establishment of different levels of cost recovery for different customer classes. Order No. 2002-761 at p. 73-74. While there are differences in the cost of gas recovery mechanisms of the two companies, the recovery of fixed upstream capacity costs based on class-specific, demand-based allocations is the same.

Q. PLEASE DISCUSS ORS'S POSITION CONCERNING MONTHLY OVER AND UNDER COLLECTION CALCULATIONS.

A. ORS has reviewed in detail the monthly over and under collection calculations required under this two-part PGA factor, and has determined that the Company's proposed methodology will fairly and accurately track actual over and under collections and allow for a smooth and orderly administration of the PGA. The Company will calculate the Firm Commodity Benchmark component of the monthly over or under collection separately from the Demand Charges component. A single Firm Commodity Benchmark will apply to all customer classes. However, an individual Demand Charges over or under calculation will be made to reflect the class specific allocation of capacity costs and a class-specific allocation of interruptible revenue credits. The Company would carry forward this customer class-specific over and under collection balance month to month based on the calculation mentioned above.

Q. PLEASE DESCRIBE THE ENVIRONMENTAL CLEAN-UP COSTS FACTOR.

A. Since Order No. 94-1117, the Company has recovered the costs of remediation of its former manufactured natural gas plant sites through a specific environmental clean-up cost ("ECC") recovery factor that is reviewed in each annual PGA. In the past PGA proceedings, the Company has provided detailed information concerning the nature of these charges and the clean-up efforts they represent. In addition, the Commission staff routinely audited the amounts in these recovery accounts.

Q. HOW WILL THE SETTLEMENT CHANGE THE ECC?

A. In the Settlement, the Parties have agreed that SCE&G will terminate the ECC factor and recover ECC costs through base rates. This will be done in two parts. SCE&G will continue to maintain an ECC deferred account which will contain ECC expenses that are unamortized at the time the Settlement rates take effect. Future ECC expenses that are deferrable will be added to this account going forward. Rather than having a per therm gas cost factor to recover the costs included in this account, the Company will instead book an annual amortization of $1.4 million against that account and will recognize a corresponding expense for accounting purposes. Non-capital related ECC expenses, specifically, the cost of routine ground water monitoring and pumping, will not be included in the amortization accounts in the future, but will be treated as standard O&M expenses.

Q. HAS ORS INVESTIGATED THE POSSIBILITY OF DOUBLE RECOVERY UNDER THIS MECHANISM?

A. Yes, we have. There will be no double recovery of costs. SCE&G will book all amounts recovered under the ECC factor against the balance in the ECC deferral account before new rates go into effect. When new rates go into effect, the ECC factor will be removed and the amortization will begin to accrue against the deferral account. ORS will review and audit ECC recoveries and deferrals in each filing made under the Rate Stabilization Act ("RSA"). Our review of the proposal indicates that there is no overlapping or double recovery under the proposal as set forth in the Settlement.

Q. PLEASE DISCUSS ORS'S CONCLUSIONS RELATED TO THE NEW DEPRECIATION RATES PROPOSED BY THE COMPANY?

A. ORS reviewed the depreciation study conducted by Mr. John Spanos as well as Mr. Spanos's direct testimony which was pre-filed in support of that study.

ORS concluded that this study is appropriate in its methodology and conclusions and that the depreciation rates recommended in the study are fair and reasonable.

As part of its audit and review of the Application in this docket, ORS compared the depreciation study to the similar study conducted by Mr. Spanos of SCE&G's electric system. That electric study was accepted for rate making and financial purposes by this Commission in Order No. 2005-2, an order approving new rates and charges for SCE&G's electric operations. The methodologies contained in the gas study are similar to those used by Mr. Spanos in his electric study. In addition, ORS specifically compared Mr. Spanos's study to the study accepted by the Commission in setting new depreciation rates for Piedmont Natural Gas Company in Order No. 2002-761. Our conclusion is that the depreciation rates proposed in Mr. Spanos' study are similar in all respects to those that the Commission approved for the Piedmont study and that the methodologies used were similar in all material respects.

Our conclusion, based both on Commission precedent and our independent review of the study, is that the depreciation study prepared by Mr. Spanos fairly and accurately reflects the appropriate depreciation rates for SCE&G's gas system.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.